

Message Text

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DEPARTMENT PASS TREASURY AND FRB

E.O. 11652: N/A

TAGS: ECON, EFIN, UK

SUBJECT: THE U.K. BUDGET; COMMENTS ON ITS ECONOMIC IMPACT

REF: LONDON 3829, LONDON 3830, LONDON 3831

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BEGIN SUMMARY: AFTER A MORE DETAILED ANALYSIS OF THE

BRITISH BUDGET, OUR INITIAL IMPRESSION IS REINFORCED THAT IT IS PARTLY A POLITICAL BUDGET, AIMING AT A NEUTRAL TO SLIGHTLY DEFLATIONARY IMPACT ON THE ECONOMY WHILE GIVING THE APPEARANCE OF A MAJOR EFFORT AT REDISTRIBUTION OF INCOME IN ORDER TO SECURE UNION COOPERATION. THE GOVERNMENT'S BUDGET ANNOUNCEMENTS HEAVILY PLACE THE BLAME FOR BRITAIN'S ECONOMIC ILLS ON THE FORMER GOVERNMENT. HOWEVER IN SUM, IT IS OUR FEELING THAT THE BUDGET MAY BE MORE DEFLATIONARY (LESS NEUTRAL) THAN THE GOVERNMENT FORESEES OR ADMITS. SOME OF THE BUDGET ELEMENTS WHICH WILL WEAKEN DEMAND WILL NOT BE IMPLEMENTED UNTIL MID-YEAR. BY THEN, THE DIRECTION OF THE ECONOMY MAY BE MORE APPARENT, AND THE PROMISED SECOND BUDGET COULD RECTIFY ANY APPARENT DEMAND WEAKNESS. HOWEVER, AT THIS POINT IT APPEARS THAT THE SECOND BUDGET IS MEANT TO CONCENTRATE ON FURTHERING THE LABOUR PARTY'S LONG-TERM ECONOMIC PROGRAM, INCLUDING INTRODUCTION OF A WEALTH TAX; IT COULD WELL COME AFTER AN ELECTION. END SUMMARY.

1. A LONGER LOOK AT THE MARCH 26 BUDGET IN ITS TOTALITY DOES NOT INSPIRE CONFIDENCE IN ITS NEUTRALITY WITH RESPECT TO DEMAND OR ITS GROWTH IMPLICATIONS FOR THE U.K. ECONOMY. IN ITSELF, THE FISCAL IMPACT (I.E., THE IMPACT OF EXPENDITURE/TAX/TRANSFER) MAY BE ONLY SLIGHTLY DAMPENING. A NET DECREASE IN EXPENDITURE OF 700 MILLION POUNDS REDUCES THE BORROWING REQUIREMENT TO 2.7 BILLION POUNDS. THUS, FY74/75 WILL STILL SEE A SUBSTANTIAL DEFICIT IN THE OVERALL PUBLIC SECTOR; THE CENTRAL GOVERNMENT ACCOUNTS WILL BE SUBSTANTIALLY IN SURPLUS, BUT OFFSET BY THE DEFICIT OF THE LOCAL AUTHORITIES AND NATIONALIZED INDUSTRIES ALTHOUGH THE LATTER HAVE BEEN REDUCED BY ABOUT ONE BILLION POUNDS BY PRICE INCREASES.

2. ONE WOULD HAVE TO KNOW THE FISCAL LEVERAGE (DIRECT DEMAND IMPACT OF EXPENDITURE/TAXES AND MULTIPLIERS) TO JUDGE THE IMPACT OF THE FISCAL MEASURES ALONE. THE INCREASES IN EXPENDITURE ARE MAINLY IN PENSIONS, HOUSING AND FOOD SUBSIDIES. WHILE THE FORMER TWO MAY NOT HAVE A FULL EFFECT ON DEMAND CREATION (0.79 ACCORDING TO TREASURY CALCULATIONS), MOST OF THE EXPENDITURE INCREASE IS IN FOOD LIMITED OFFICIAL USE

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SUBSIDIES. THE DIRECT DEMAND EFFECT OF THESE IS LIKELY TO BE NEAR 1.

3. THE INCREASE IN TAX REVENUE OF 1.4 BILLION POUNDS HAS LESS DIRECT DAMPENING EFFECT ON DEMAND. ALTHOUGH 585 MILLION POUNDS COMES FROM INDIRECT TAXATION(MOST ON ITEMS WHICH ARE FAIRLY INELASTIC IN DEMAND) AND 267 MILLION POUNDS FROM INCREASES IN PERSONAL INCOME TAX (MUCH FROM

MIDDLE INCOME GROUPS), 500 MILLION POUNDS COMES FROM CORPORATE TAX AND FROM STAMP DUTIES WHICH PROBABLY HAVE LESS DIRECT DEMAND EFFECT.

4. WHETHER AUTOMATIC EFFECTS OF U.K. BUDGET POLICY (I.E., THE CHANGE IN REVENUE INDUCED BY CHANGES IN INCOME) WILL WORK TO REINFORCE THE IMPACT OF THE DEFLATIONARY DISCRETIONARY BUDGET CHANGES IS NOT CERTAIN. THE OECD STUDY BY BENT HANSEN FOUND THAT SUCH AUTOMATIC EFFECTS DID WORK PRO-CYCLICALLY IN THE 1960S--THEY LENT IMPETUS TO THE DIRECTION THE ECONOMY WAS GOING INSTEAD OF WORKING TO OFFSET IT AS THEY SHOULD. THIS WAS MAINLY DUE TO THE TAX COLLECTION SYSTEM IN WHICH THERE WERE GREAT LAGS. THE PRESENT TAX SYSTEM MAY MEAN THAT AUTOMATIC CHANGES WOULD WORK--AS THEY SHOULD IN THEORY--TO OFFSET THE CYCLE; IN

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THIS CASE THEY WOULD WORK TO OFFSET THE DEFLATIONARY
FISCAL POLICY.

5. THUS, WE WOULD JUDGE THE IMPACT OF PUBLIC SECTOR NET
SPENDING CHANGES TO BE SLIGHTLY DEFLATIONARY. BUT THE
DEFLATIONARY ELEMENT OF THE BUDGET IS SEEN MORE CLEARLY
OUTSIDE OF THE EXPENDITURE/TAX/TRANSFER MECHANISM. PRICE
INCREASES WERE ANNOUNCED FOR STEEL, ELECTRICITY, COAL,
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RAIL TRANSPORT, AND POSTAL RATES. THESE IMPLY A GENERAL
RISE IN THE PRICE LEVEL. ADDING THESE TO THE INDIRECT
TAX INCREASES (VAT ON GASOLINE, CONFECTIONARY AND OTHER
LUXURY FOODS, AND HIGHER EXCISE TAXES ON ALCOHOL,
CIGARETTES AND BETTING -- ALL FAIRLY INELASTIC IN DEMAND
WE BELIEVE) ONE CONCLUDES THAT DEMAND AS A WHOLE WILL BE
WEAKENED. (IT SHOULD BE NOTED THAT COAL PRICE INCREASES
OF UP TO 48 PERCENT HAD ALREADY BEEN ANNOUNCED PRIOR TO
THE BUDGET, AND WILL GO UP AGAIN IN THE AUTUMN). THE
FINANCIAL TIMES ESTIMATES ALL THESE PRICE INCREASES WILL
ADD 2.5 TO 3 PERCENT TO RETAIL PRICE GROWTH; ECONOMIC
WRITER ANTHONY HARRIS ESTIMATES A DEMAND DEPRESSION
EFFECT (IN EARLY 1975) OF ONE PERCENT OF GNP. THESE
FIGURES ARE JUST "GUESSTIMATES," BUT WE BELIEVE THEY ARE
IN THE RIGHT DIRECTION. (SHADOW CHANCELLOR CARR CLAIMED
THAT U.K. TREASURY FIGURES SHOWED 2.5 PERCENT
ADDITIONAL GROWTH IN RETAIL PRICES FROM THE BUDGET
MEASURES; EDMUND DELL, PAYMASTER GENERAL (SECOND TO
HEALEY AT TREASURY) REPLIED THAT THE GOVERNMENT BELIEVED
THE MEASURES WOULD ADD ONLY 1.5 PERCENT TO INFLATION.)

6. MR. HEALEY WILL HAVE HIS SECOND BUDGET TO SHIFT
DIRECTION, IF HE CHOOSES, ESPECIALLY IF FORECASTS AND
ACTUAL TRENDS APPEARING BY THIS AUTUMN BEAR OUT THESE
BEARISH THOUGHTS. ONE DIFFICULTY FOR POLICY PLANNING IS
THAT THE TOOL OF A REFLATIONARY POLICY UNDER THIS GOVERN-
MENT WOULD PROBABLY BE FISCAL POLICY (EXPENDITURE),
WHOSE LAGS APPEAR LONG AND UNCERTAIN IN THE U.K. THE
OECD FOUND IN A 1968 STUDY A SEVEN TO NINE-MONTH LAG
BETWEEN PRODUCTION/EMPLOYMENT AND PRICES/WAGES/PERSONAL
INCOME. THUS, AN AUTUMN REFLATIONARY BUDGET TO

STIMULATE DEMAND WOULD HAVE ITS EFFECT IN LATE 1975.

7. EQUALLY SERIOUS FOR BOTH THE SHORT AND LONG TERM IS THE BUDGET'S EFFECT ON THE PRIVATE SECTOR'S INVESTMENT PLANS. THESE HAVE BEEN DAMPENED SOMEWHAT BY THE EFFECTS OF THE THREE-DAY WEEK WHICH CREATED MATERIAL SHORTAGES AND CASH FLOW PROBLEMS WHICH WILL DELAY RECOVERY OF SOME INDUSTRIES. ADD TO THIS THE NEW PRICE REGULATIONS CUTTING ALLOWABLE GROSS PROFIT MARGINS FOR RETAILERS/WHOLESALERS, A HIGHER CORPORATION TAX AND LIMITED OFFICIAL USE

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ACCELERATED PAYMENTS, RISING PRICES FOR ELECTRICITY, COAL, TRANSPORT, INCREASED EMPLOYERS' CONTRIBUTIONS TO NATIONAL INSURANCE (EMPLOYEES' CONTRIBUTIONS WERE REDUCED), AND RISING WAGE BILLS DUE TO UNION DEMANDS AND THE WORKING OF STAGE 3'S ESCALATOR CLAUSE, AND THE SUM IS A REAL SQUEEZE ON COMPANY LIQUIDITY. WITH BUSINESS CONFIDENCE ALREADY AT A LOW, INVESTMENT PLANS ARE LIKELY TO BE DAMPENED FURTHER.

8. THERE HAS, IN THE PAST, BEEN LITTLE INDICATION THAT BUSINESS INVESTMENT IN THE U.K. IS RESPONSIVE TO INTEREST RATES, BUT THE PRESENT HIGH LEVEL OF INTEREST RATES IS UNLIKELY TO ENCOURAGE BORROWING FOR INVESTMENT PURPOSES. A LIQUIDITY SQUEEZE, UNLESS OFFSET BY THE BANK OF ENGLAND, WOULD EXACERBATE A SLUMP, IN PART BY HEIGHTENING THE INVENTORY ACCUMULATION CYCLE AND BY ITS EFFECTS ON HOME BUILDING AND PURCHASING. (THERE WILL BE A PUSH TO BUILD INVENTORIES IN THE NEXT FEW MONTHS AND AN OBVIOUS REDUCTION OF THIS LATER THIS YEAR.) THE CONFEDERATION OF BRITISH INDUSTRY (CBI) ANNOUNCED MARCH 27 THAT IT CALCULATED THE BUDGET MEASURES WOULD REDUCE COMPANY LIQUIDITY BY 1.1 BILLION POUNDS. CBI CALLED THE BUDGET "CLOUD-CUCKOO-LAND ECONOMICS," AND CBI LEADER CALLED IT "ANTI-INDUSTRY." THE INVESTMENT IMPACT WAS THE OTHER MAJOR CRITICISM OF CONSERVATIVE SHADOW CHANCELLOR CARR.

9. THE CONCLUSION MUST BE THAT THIS IS A DEFLATIONARY BUDGET WHICH NOT ONLY WILL REDUCE ECONOMIC ACTIVITY IN THE SHORT RUN BUT WILL HAVE AN EFFECT ON LONG-TERM GROWTH AND ITS COMPONENTS. IT HAS BEEN DELIBERATELY DRAFTED TO INCLUDE THE FOLLOWING TWO OBJECTIVES: (1) SECURING TRADE UNION COOPERATION IN MODERATING WAGE CLAIMS (THE "SOCIAL CONTRACT") BY TAKING THE FIRST STEP AT REDISTRIBUTING INCOME THROUGH THE TAX/TRANSFER MECHANISM; (2) CHANNELING RESOURCES INTO THE EXPORT SECTOR TO
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RECTIFY THE NON-OIL CURRENT ACCOUNT DEFICIT IN THE LONGER
TERM (THE PRICING REGULATIONS, WHICH LIMIT PROFIT MARGINS
IN THE DOMESTIC MARKET BUT HAVE NO SUCH LIMITATION ON
PROFITS FROM EXPORT SALES, SEEM TO FIT THIS DESIGN). IF
THE GOVERNMENT SUCCEEDS IN ACHIEVING THESE OBJECTIVES,
IT WILL BE A NOTABLE ACHIEVEMENT AND SHOULD GO FAR TO
MAINTAIN INTERNATIONAL CONFIDENCE, ENABLING THE U.K.
TO BORROW ABROAD TO COVER ITS BALANCE OF PAYMENTS DEFICIT.
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BUT THE TRANSFER OF RESOURCES TO EXPORTS WILL TAKE TIME. THERE IS ALSO THE QUESTION OF THE GROWTH OF EXPORT MARKETS IN THIS YEAR OF THE ENERGY SHORTAGE AND OIL PRICE RISES AS WELL AS THE QUESTION OF WHETHER SOME EXPORT MARKETS HAVEN'T BEEN LOST DURING THE THREE-DAY WEEK.

10. MOREOVER, THERE IS A QUESTION AS TO WHETHER THE TUC CAN ACTUALLY DELIVER ON ITS "SOCIAL CONTRACT," PARTICULARLY WITH THE PROSPECT OF RETAIL PRICE RISE OF 15 PERCENT OR MORE IN 1974. ALSO, THE TUC IS COMMITTED TO FULL EMPLOYMENT, A STEADY, HIGH-AS-POSSIBLE GROWTH RATE, WHICH THIS BUDGET DOES NOT SEEM TO IMPLY.

11. THUS, THE INITIAL JUDGMENT MUST BE THAT THIS BUDGET IS AN INDICATION OF THE GOVERNMENT'S PRIORITY PRIORITIES, BUT THAT THE SUCCESS OF ITS AIMS ARE PROBLEMATIC. IT WILL DEPEND IN LARGE MEASURE ON COOPERATION AND RESTRAINT FROM THE UNIONS, A MAJOR EFFORT OF U.K. FIRMS TO DEVELOP EXPORT MARKETS, USING THE RESOURCES BEING MADE AVAILABLE WITHIN THE DOMESTIC ECONOMY, AND THE ABILITY AND WILLINGNESS OF INDUSTRY TO INVEST IN NEW PLANT AND EQUIPMENT IN THE FACE OF A LIQUIDITY SQUEEZE, REDUCED PROFITS, AND SHAKEN CONFIDENCE.

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